



## USAID Croatia



# Graduation Plan

**FY2004 – FY2008**

June 2003

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# **1 GRADUATION PLAN**

## **1.1 Overview**

Croatia's political and economic transition will soon reach a stage in its economic and democratic transition where USG assistance will no longer be necessary. In response the U.S. Administration has determined that bilateral funding will end in FY 2006 and the U.S. Mission to Croatia has prepared this graduation plan.

Croatia has been building the elements of a participatory democracy and market-oriented economy since January 2000, with the election of a reformist coalition government. Croatia sees its future in full integration into the EU, where the engine for future growth lies, although wrenching societal changes will surely be needed to let it compete and thrive in the international marketplace. The U.S. Mission's eyes are on twin goals: closing the gap of economic and democratic reform indicators to something close to Northern Tier graduation standards; and, in a few key areas, strengthening the underpinnings for the fundamental systemic and institutional changes which must come if Croatia is to be fully integrated into the European Union.

Croatia is lining up to join the EU as soon as possible. It signed and ratified a Stabilization and Association Agreement (SAA) with the European Union in late 2001. Ratification of the SAA by EU member states will take up to another year. Croatia formally applied for EU membership in February 2003. The Stabilization and Association process is distinct from that for eventual membership, but the Commission in its SAA progress reports reforms it expects from Croatia, against which it will assess Croatia's application. The European Commission will probably send its *avis* on Croatia's application to the EU Council in spring 2004. The Council will then decide whether to open membership negotiations with Croatia, which is probable, or defer them pending further reforms.

EU accession requirements include harmonization of laws, standards and procedures, capacity-building in government institutions, improvement of international immigration regimes, and compliance with commitments regarding return and reintegration of refugees and displaced persons and cooperation with the International Criminal Tribunal for the former Yugoslavia (ICTY). Significant aid flows from the EU and the International Financial Institutions (IFIs) will bridge the gap following our graduation in 2006 and close-out in 2008.

Croatia's economy although robust in comparison to other East European countries, continues to perform below potential. It is still plagued by a high unemployment rate (16%) and low competitive capacity in international markets. The moderate progress the government made over the last two years in reducing the fiscal deficit could be threatened as upcoming elections draw nearer. In order for progress to date to translate into sustainable

economic growth and eventually lower unemployment, the government must accelerate privatization, reduce bureaucracy, and improve the investment climate. There is a need for increased effort against corruption through more effective application of the rule of law, particularly improvement in the court system. For the balance of its time here, USAID's private sector focus will be on the creation of a vibrant small and medium enterprise (SME) sector, including agriculture, as the engine for sustainable job creation.

Croatia's democratic transition has been less impressive. It lags Northern Tier states on all major reform indicators, although there have been significant improvements since 2000 in free and fair elections, civil society, independent media, improved governance, and rule of law. The USAID democracy program will maintain its emphasis in raising democratic standards related to local governance, participatory civil society, and better political processes and parties.

## ***1.2 U.S. Foreign Policy Interests***

A Europe whole, free and at peace remains the overriding U.S. interest in South Central Europe. The countries in the Balkan region suffer not only from their communist past, but in most cases, also from a recent legacy of war, ethnic violence and devastating social upheaval.

As America's global priorities have shifted, assistance to the Balkans, including Croatia, is declining. Much remains to be done to promote and consolidate reforms, cement Croatia's departure from the wartime legacy of ethnic nationalism and prepare it for intensive, fruitful cooperation with the European Union and IFIs. Solidifying neighborly relations, active promotion of refugee reintegration and full cooperation with the International War Crimes Tribunal for the former Yugoslavia are Croatia's as-yet incomplete contributions to regional stability.

## ***1.3 Consolidation and Strategic Priorities***

To ensure that scarce financial and management resources are focused on our core concerns, USAID's portfolio will be consolidated beginning in FY 2004 from the current four Strategic Objective areas to two, corresponding to our interest in a dynamic private sector and participatory democratic governance. Management units (contracts and cooperative agreements) will be reduced by October 1, 2004 from 28 to about eight to ten.

Creating a dynamic and competitive private sector and more effective citizen participation in government will be the focus of our remaining assistance in line with the decision of the interagency review.

Our existing program to accelerate return and sustainable reintegration of war-affected populations, Strategic Objective (SO) 3.1, will end as planned in 2004. However, USAID assistance will continue to target resources within its mainstream economic and democracy programs to improve opportunities in war-affected communities and improve the environment for sustainable returns. (Lack of such opportunity is often cited by potential returnees as a reason they have chosen not to return.) USAID's current efforts to create jobs in war-affected areas now carried out under SO 3.1 will be incorporated into SO 1.3's more comprehensive approach to private sector-led employment growth, and benefit from the national and regional linkages made there. At the same time, local governance efforts will expand more widely and deliberately into these lesser-developed areas. Thus a parallel effort within our two main program areas will ensure that lesser developed/war-affected areas are not left behind to become sources of unrest and instability.

USAID's program for mitigating adverse social conditions and trends, SO 3.4, will also be wrapped up in September 2004. This SO which has significant synergies with all the strategic areas, was undertaken as a result of increased resources appropriated by Congress. Now with diminishing resources and a set graduation date, the Mission has determined that activities which merit continued support within this SO should be merged into the main program. USG transnational concerns regarding vulnerable groups now addressed in SO 3.4, such as Anti-Trafficking in Persons, will now be integrated into our democracy strategic area for as long as funding is available.

Activities which are coming to a successful close or which, in a graduation scenario, are no longer priorities for funding will end by October 1, 2004. These include: Fiscal Reform; Advisor to the Deputy Prime Minister; Privatization; Bank Supervision; Competitiveness; Commercial Law; Municipal Court Modernization; Independent Media Development; Political Party and Legislative Strengthening; Judicial Training; Labor; Tripartite Dialogue; Pension Reform; Community Infrastructure Rehabilitation; and, as a stand-alone, Economic and Community Revitalization in war-affected areas. Upcoming parliamentary elections to be held between November 2003 to February 2004 may affect the pace at which some activities close, if there are reinvigorated opportunities to have real impact in the short period remaining.

#### **1.4 The Goal**

USAID's overarching goal for Croatia remains the development of a fully democratic society and productive market economy that together serve as a cornerstone for prosperity and stability in the region. There are two preconditions for Croatia to achieve this goal, each of which corresponds to one of USAID/Croatia's Strategic Objectives. The first is the development of conditions that foster competition and constantly increasing productivity, innovation and job creation in a vigorous private sector-led economy. The second, no less important, is the building of a transparent, accountable and

effective political system at central and local levels that is responsive to citizen needs and fundamental principles of democracy and human rights.

## 1.5 Focus

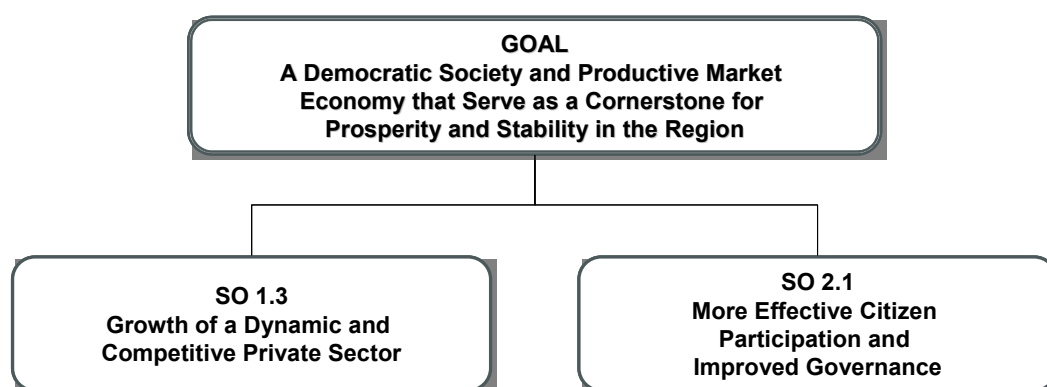
Under the graduation plan, SEED assistance will focus on three key areas:

**Local Government Reform:** Croatia's decentralization effort has placed heavy administrative and fiscal demands on the country's 567 local governments. USAID's Local Government Reform Project addresses these demands by introducing public administration practices, transparency, and citizen participation to municipalities throughout the country. The result of our continued efforts in this sector will be a critical mass of communities which are responsive to citizens' needs, financially viable, and delivering services more efficiently and effectively. Under our graduation scenario, we expect future EU and World Bank activities in this sector will build upon our programs.

**NGO Capacity Building:** Nongovernmental organizations will serve as the voice for on-going reform and fill the gap in social services not provided by the government. Recognizing their potential in the post-war environment, USAID began assisting NGOs in the mid-1990s and is now developing a sustainable core of nine sectoral and three grant-giving institutions. Expanded assistance to those NGO partners and others will develop them as legacy mechanisms, and ensure that they will be able to diversify their funding base and improve their financial sustainability.

**SME and Agribusiness Development:** Unemployment, hovering at over 16%, may be the most critical threat to Croatia's progress toward long term political and economic stability and integration into western institutions. The next several years will be the most challenging as the restructuring/privatization process and the lowering of import barriers to the EU will result in the loss of tens of thousands of jobs from inefficient state-owned enterprises. A growing and dynamic small and medium enterprise sector must be the engine of growth and the source of new jobs, but poor managerial and entrepreneurial skills in Croatian SMEs are a major problem.

Figure 1: Strategic Framework FY2004-FY2008



The EU, IMF and World Bank are poised to engage in significant programs of structural economic and public administration reform, areas that are important to an improved investment climate. These institutions do not address SME and agribusiness development. USAID's economic development programs are accordingly shifting to activities that directly support entrepreneurship and SME development.

## **1.6 Basic Assumptions**

A number of conditions beyond USAID's control must be met or maintained in order to achieve successful results in this graduation plan. These are necessary for an appropriate political and economic environment that supports attainment of both Strategic Objectives. Lower-level assumptions are identified in the discussion of individual SOs.

Overarching assumptions are:

- Peace will prevail in the states of the former Yugoslavia, with no conflicts or outbreaks of hostilities in the region, and democratic transition will continue to advance in a post-Milosevic Serbia.
- Transition in the political process and the economy will continue through normal processes inherent in open societies and markets.
- Government elected in late 2003/early 2004 will continue Croatia's commitment to the democratic and economic reforms required for EU accession and integration into other Euro-Atlantic institutions.
- The Croatian Government will maintain its obligation to comply with the Dayton and Erdut agreements and fully cooperate with the International War Crimes Tribunal for former Yugoslavia.
- The GOC will introduce judicial and public administration reforms in systematic fashion. These reforms conform to EU/Council of Europe standards.

## **1.7 Other Donors**

Croatia's ratification of a Stabilization and Association Agreement (SAA) and application for candidacy to join the European Union marked an important step toward accession. The SAA made Croatia eligible for pre-accession assistance under the EU/CARDS program. The bulk of EU assistance will be directed to activities that directly support movement toward accession through harmonization of laws, standards and procedures; capacity-building in government institutions, improvement of international immigration regimes, and economic and social development. The EU has developed a 36 million Euro start-up program for 2001; and a five-year strategy for 2002-2006 averaging about 70 million Euros annually. The long and multi-step procedures used by the EU delay implementation, hence the 2001 program is

just coming on line in 2003, and will take some time to show results. Nevertheless, the EU will be the major donor for the long haul, and has much greater leverage, not only in achieving systemic judicial and public administration reforms, but also in pressing for effective support of ethnic reconciliation and reintegration, and for cooperation with the International Criminal Tribunal, which are required for accession.

With USAID funding through FY 2006, there should be a relatively seamless transition to EU and IFI support in the reform areas we have supported. Bridges between USAID and other programs include

- Court modernization, where USAID's Municipal and Commercial Court case management assistance will be rolled out by the EU and World Bank;
- Removal of administrative barriers, to improve the investment climate;
- Training of judiciary and court personnel;
- Public Administration reform, including the judicial sector, under World Bank assistance;
- Support to land cadastre and land registry reform. USAID has developed several pilot approaches which the EU and World Bank will implement;
- Local governance, where the EU is working at the national level to increase fiscal decentralization. Achieving greater revenue authority is crucial to the long run viability of local governments;
- Potentially, the creation with EU assistance of a public administration institution or university department to improve the professionalism of central government civil servants. USAID will explore this under LGRP II;
- Increased transparency and fairness in application of procedures to assist full integration of minority groups;
- Democratic stabilization and increased social service delivery by NGOs through small grants, advocacy and networking;
- Improved legal and institutional framework to prevent corruption;
- EU support to economic development in war-affected areas and World Bank lending for economic, infrastructure and social needs in economically disadvantaged areas;
- World Bank loan support for implementation of the new pension system, for which USAID implemented a successful public education program;
- World Bank support for enabling legislation for micro-finance institutions, as part of the Structural Adjustment Loan negotiations;
- Support for a new labor law to address rigid labor markets;
- EU Development of Internal Audit and Debt Management functions in the Ministry of Finance, for which USAID advisers have laid the groundwork.



## **2 Strategic Objective 1.3 – Growth of a Dynamic and Competitive Private Sector**

As part of the USAID/Croatia graduation plan, the Mission has modified certain aspects of its economic program in order to better achieve its projected results with the remaining time and resources. The following section describes in detail the shift in focus, the expected results and the legacy we will leave behind for Croatia's private sector.

### ***2.1 Modification of Intermediate Results***

Five Intermediate Results have been identified as necessary during the period FY 2004-2006 to achieve the overarching Strategic Objective of the growth of a dynamic and competitive private sector. (See Fig. 2.) These include: (1) *Creation of a Competitive Power Market*; (2) *Strengthened Capacity of SMEs to Operate and Compete*; (3) *Increased Employment and Growth in Lesser Developed Areas*; (4) *Competitive, Transparent Privatization of State-Owned Enterprises*; and (5) *Improved Investment Climate*. IRs 1.3.2, 1.3.4 and 1.3.5 are from the original strategic framework. IR 1.3.3 has been moved from SO 3.1 to include targeted economic revitalization assistance in Croatia's lesser developed and war-affected regions. IR 1.3.1 is new, based on an increased emphasis on Croatia's regional energy program. The results framework diagram identifies six lower level IRs which support these five Intermediate Results.

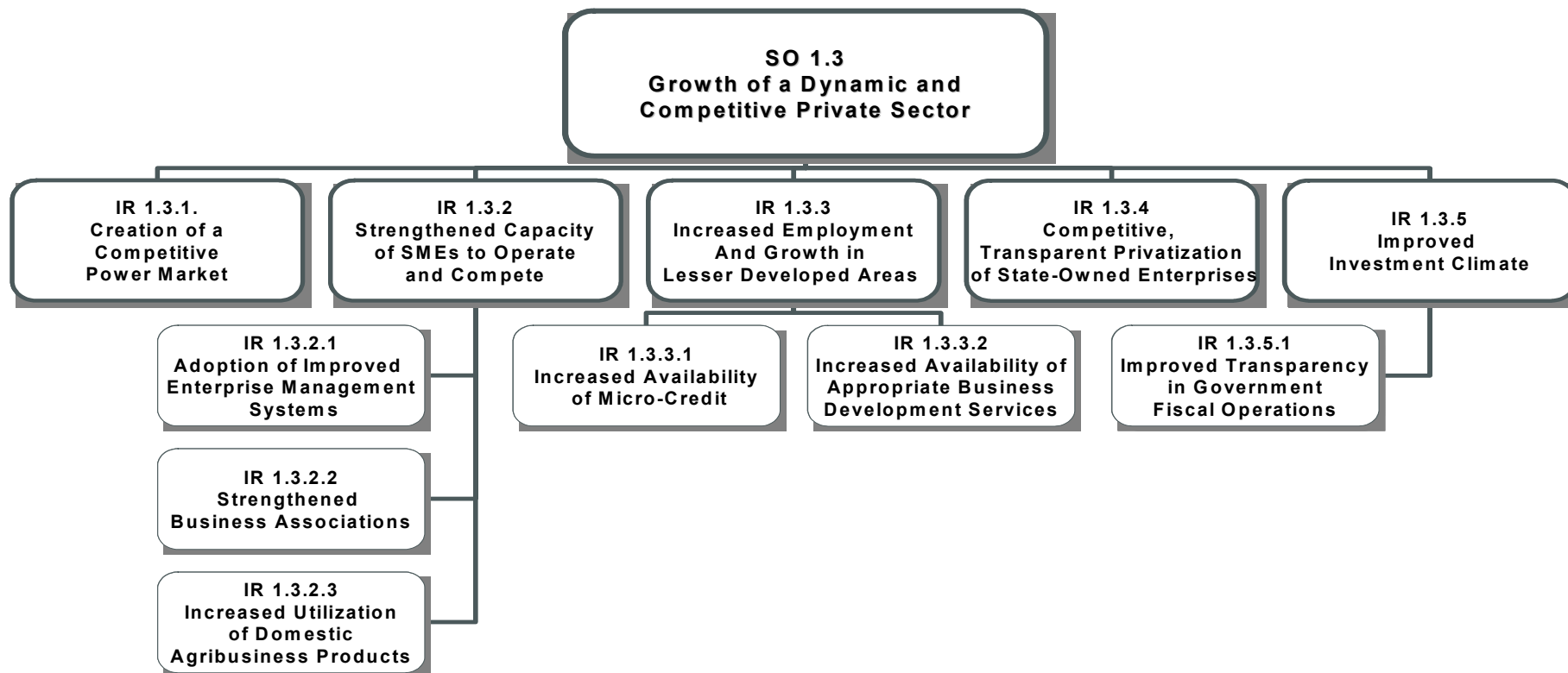
The strategic framework will evolve as many current activities are completed and the SME focus becomes predominant. Mission efforts in Fiscal Reform, advisory services to the Deputy Prime Minister, Privatization, Bank Supervision, Commercial Law and Competitiveness will all be completed by the end of FY 2004, or shortly thereafter. During the FY 2004-2006 period, Intermediate Results for *Competitive, Transparent Privatization of State Owned Enterprises*, and *Improved Investment Climate* will therefore be completed as well. By FY 2006 or before, activities supporting IR 1.3.1, IR1.3.4, and IR 1.3.5 will have been completed and these IRs will no longer pertain during the closeout period of FY 2006-2008 (see Figure 3).

### ***2.2 Purpose and Shift of Emphasis***

Under Objective 1.3, USAID has supported macroeconomic and structural reforms to improve the enabling environment for private sector growth. USG assistance in structural and policy reform has achieved strong results in several key areas over a relatively short period, for example, enabling the Ministry of

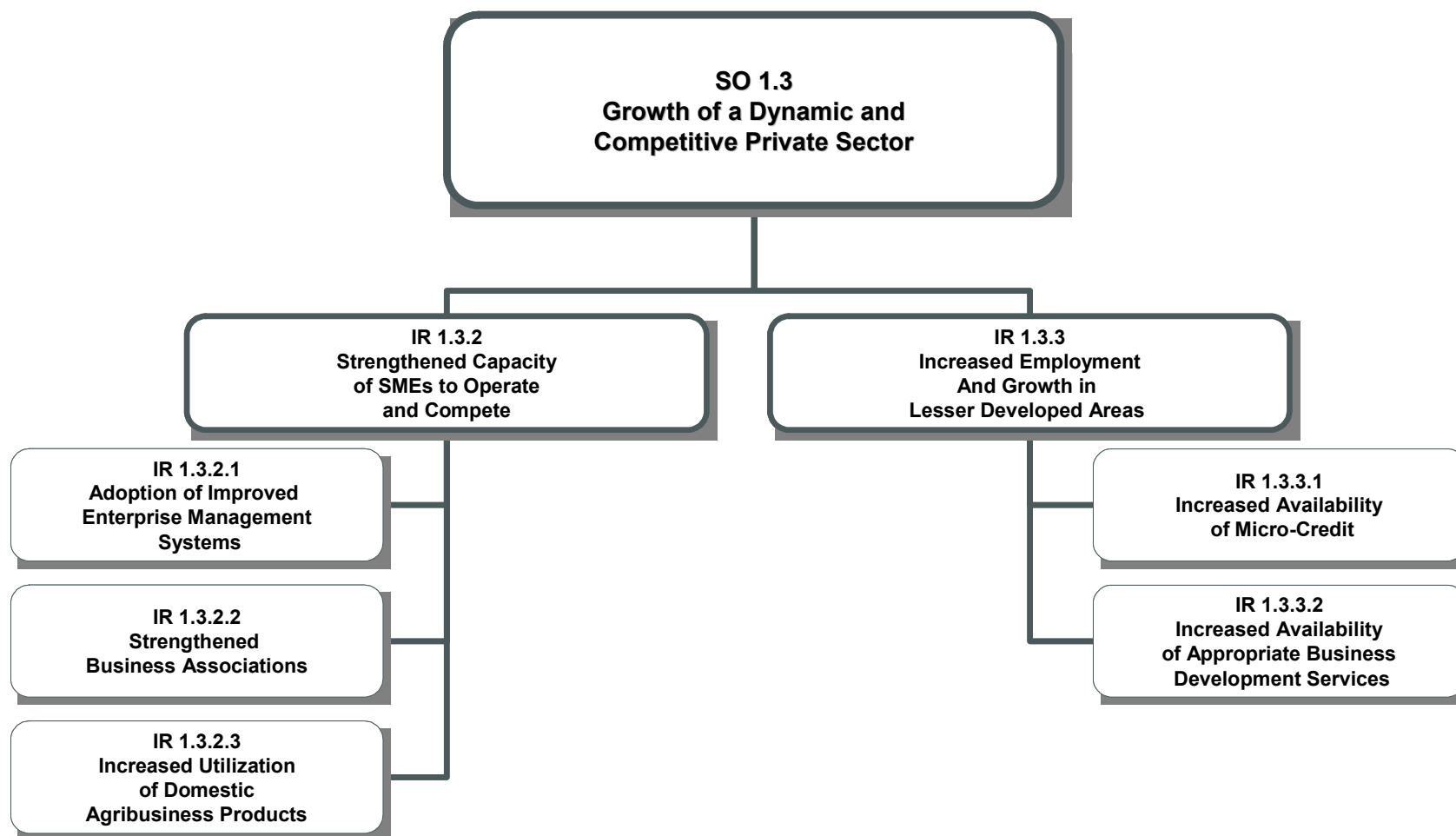
**Figure 2:**

**SO 1.3 Strategic Framework  
FY2004-FY2006**



**Figure 3:**

**SO 1.3 Strategic Framework  
FY2006-FY2008**



Finance to meet IMF Stand-By requirements and strengthening the Central Bank's capacity for regulatory oversight. While Croatia needs further development of its legal and regulatory framework to solidify macroeconomic stability and spur economic growth, much of USAID's assistance in this area serves as the groundwork for continued systemic reform supported by other donors. Significant new EU/CARDS and World Bank-funded structural reform programs are beginning or being planned in many areas in which USAID has worked, such as land registry/cadastre, fiscal reform, decentralization, pension reform and the justice sector.

USAID will therefore consolidate and focus most of its assistance in this Strategic Objective area on efforts that directly support entrepreneurship and SME development. Focus will be given to stimulating and addressing demand for these programs in the lesser-developed areas of Croatia, including war-affected areas. Thus as the program moves over the next year from four Strategic Objectives to two, SO 1.3 will make programmatic adjustments to incorporate specific activity components which are a current emphasis under the SO 3.1, Accelerated Return and Sustainable Reintegration of War-Affected Populations. This decision grew in part from a December 2002 mid-term evaluation of the Economic and Community Revitalization Activity under SO 3.1, which found that more sustainable return and reintegration would result from greater emphasis on economic growth and job creation rather than community building initiatives.

➤ IR 1.3.1: Creation of a Competitive Power Market

*Energy:* The addition to the Strategic Framework of IR 1.3.1, *Creation of a Competitive Power Market*, reflects increased emphasis on Croatia's regional energy program, given a newly receptive policy environment. Two years' effort in support of a legal framework and institutional development of an independent, competent regulatory agency now appears to be paying off. Croatia has recently signed a Memorandum of Understanding among nine countries of South East Europe to establish an integrated regional electricity market by 2005, and ensure its integration into the European Union's Internal Electricity Market. This is highly significant to ensuring transparent and market-based power generation, transmission and distribution to support Croatia's efficient industrial growth, and is essential to its eventual accession into the EU. Regionally funded technical assistance will continue to help Croatia implement its commitments under this agreement. Outputs will include: establishing a strong and transparent regulatory agency, harmonization of transmission tariffs, and the unbundling of accounts and other requirements for the functioning of effective regional markets. The significance of this effort, which supports an important U.S. foreign policy objective of assisting Croatia's integration with its neighbors and with EU institutions, merits establishment of a specific Intermediate Result. Given the expectation that the integrated regional electricity market will be established by 2005, this IR will be completed by FY 2006.

- IR 1.3.2: Strengthened Capacity of SMEs to Operate and Compete
- IR 1.3.3: Increased Employment and Growth in Lesser Developed Areas

Programs in enterprise promotion and agribusiness development form the major elements of these two Intermediate Results. The programs are closely associated in their purposes, mutually reinforcing, and will comprise the bulk of USAID's resources and attention in private sector development from now through graduation and closeout.

*Enterprise Promotion:* The Croatia Enterprise Promotion program, CEP, is focused on improving the quality and exportability of the goods and services of Croatian SMEs by providing business development services (BDS) to those enterprises through Croatian consultants. Among the most important of the services being provided are those that are assisting enterprises in the adoption of international standards (e.g. ISO and HAACP), that will allow Croatian products to enter the global marketplace. In addition, comprehensive training through an association of management trainers is promoting professionalism and developing a code of conduct for BDS providers. The final year of the current project will concentrate on the roll-out of these modern BDS services country-wide, with specific attention to the needs of smaller and less capable entrepreneurs in Croatia's lesser developed areas.

A new follow-on SME development program now in the design process will broaden the range of activities and geographic scope of the current CEP program while adding several new interrelated components. In addition to building a cadre of over two hundred expert and financially sustainable business services consultants and firms, the new program will provide firm-level technical assistance directly to over 1,000 enterprises country-wide. Assistance will be provided at both the national strategic level and the firm level to SMEs in industry clusters that will include Tourism, Wood Products, Information Technology and several others. A major new component of the SME development program will begin to address the access to finance problems faced by SMEs, especially in the lesser developed areas, through the further development of micro-finance and other financial services (e.g. leasing).

Sustainability within the more advanced business sector is straightforward. Business services sector consultant capacity will be built as businesses receive services through practicum on a fee-for-service basis. In moving into the less advanced business sector within the war-affected regions, full cost recovery for consultant services may not be possible initially. The project will develop local (and lower cost, compared to urban-based services) consultant capacity, and will introduce basic, primary business skills which should have immediate impact on the profitability of small businesses. The expectation is that by program end the resulting higher profitability will allow these enterprises to also pay for additional, higher-end business and financial

services and that over time, viable local consultancy businesses will thrive there as well.

*Agriculture:* SME development is essential to help Croatian agribusinesses face the daunting challenge of competing directly with heavily subsidized EU agriculture. There is great potential to expand domestic production of many agricultural products which are currently imported. The FY 2003-initiated Agribusiness Competitiveness Enhancement program, ACE, focuses on development of market linkages among producers, traders, processors and tourism-related enterprises. The project currently seeks to achieve immediate and maximum economic impact for Croatia by seeking high return opportunities within the commercial farm sector including horticulture, dairy and swine products. ACE will provide direct technical assistance to over 3,000 commercial agricultural producers and approximately 100 agribusiness enterprises. By developing effective support systems for producers and by strengthening the linkages among producers, processors and their markets, the project will enable producers and agribusiness enterprises to meet market demand, reduce costs and enhance competitiveness for domestic products. Sustainable improvements to linkages and processes are therefore anticipated results. Consultant services available through CEP will complement these efforts to build a competitive agribusiness sector.

Unemployment is at critically high levels in lesser developed areas. Given that agriculture is one of the few possible avenues to economic development and employment generation in the lesser developed areas of Croatia, this program is of critical importance to the USG strategic goal of regional stability. Although a recent start, ACE's design is currently being expanded to add a direct focus in the more distressed, lesser developed and war affected areas, in order to address the job and growth objectives previously covered under SO 3.1. This will likely require greater direct farm-level assistance and financing, as many small-scale, even subsistence-level farmers, input suppliers, processors and marketers in these regions are not now able to participate effectively in commercial farm-to-market linkages. The project will help form cooperatives or other means of aggregating their impact. Project resources applied over four years will have a significant impact in developing a commercially viable agribusiness sector in lesser developed and war-affected areas.

➤ IR 1.3.4: Competitive, Transparent Privatization of State-Owned Enterprises

USAID's privatization support is helping the Croatian Privatization Fund divest state ownership in hundreds of enterprises, excluding those largest parastatals deemed "strategic assets", through open, competitive and transparent processes. Tender preparation, investor outreach and public education on the program have resulted in significant restructuring and sales, and an improved public perception of the process. However, recent politicization of

the program in the run-up to Parliamentary elections has slowed implementation and USAID support has been scaled back.

If a reinvigorated government commitment emerges post-election, (as is likely, because all political parties acknowledge the drag on Croatia's economy represented by inefficient and non-productive state enterprises), assistance will be continued to complete tendering and sale of the remaining 170 enterprises in the Fund's portfolio, including in areas of real potential for Croatia's competitiveness, such as tourism, hotels, and agrokombinati. This activity so far has helped to generate over \$130 million in revenues for the Croatian Government.

Support for privatization has helped create a transparent, competitive process that is moving productive assets into the private sector, but the Croatian economy remains saddled with the largest state-owned enterprises, which are deemed strategic, such as oil and gas, and power. USAID has neither the resources, time, nor leverage to have a major impact here, but we may be able to assist with elements where there is a tie in to our existing program, such as through public education to explain the reform process. We anticipate completion of this IR by FY 2005.

➤ IR 1.3.5: Improved Investment Climate

Ongoing USG economic programs focusing on macroeconomic and structural reforms have supported GOC policy changes and are the principal mechanisms for the U.S. to positively affect private sector growth and investment. USAID and U.S. Treasury advisors assist the Ministry of Finance in modern financial management and accounting systems and decentralization legislation and strategy, as well as in meeting reform benchmarks for both IMF and World Bank programs. Support in bank supervision is improving regulatory oversight and strengthening the banking system. The Croatian Competitiveness Initiative has focused the attention of private and governmental actors on the need to reduce impediments to Croatia's international competitiveness and has highlighted opportunities in business sectors with most potential, such as tourism, wood products and information technology.

A recent key success will address one element of a critical impediment to investment and to accession to the EU - Croatia's poor judicial system - and affirms USAID's plan to leave broader judicial reform to other donors who have greater leverage to bear. In an important break-through, international donors and the Government of Croatia have agreed to implement a standardized court and case management system throughout Croatia. The new software platform, based on USAID's work with municipal and commercial court systems, promises to significantly improve efficiency by reducing multi-year case backlogs, improving communication among courts and lowering maintenance costs. A unified donor approach to the GOC brought this decision about, and illustrates excellent coordination among

USAID, EU and the World Bank. USAID will complete specifications and the Bank and EU will roll out the technology and training for the new system.

As the EU accession process moves forward and becomes increasingly the focus of GOC reform efforts in the mid and later years of this graduation strategy, USAID will target its much reduced efforts to those areas where small amounts of resources can have strong impact because of our historical engagement and successes in those fields. These might include, for example, further strengthening of regulatory agencies (e.g. banking and pension supervision, energy regulation); further support to the inter-ministerial working groups addressing the barriers to investment identified in the FIAS report; and ad hoc assistance to the National Competitiveness Council.

### **2.3 Critical Assumptions**

- The GOC remains stable with a continuing commitment to economic reform;
- The GOC continues on its path toward EU accession;
- EU and World Bank programs address systemic public administration and judicial reform needs.

### **2.4 Sustainability – Legacy Mechanisms**

The following organizations and/or institutions will maintain the momentum of Croatia's transition to a market-oriented economy and sustain previous U.S. initiatives.

A sustainable, vibrant and growing small and medium enterprise sector contributing to economic growth and sustainable job creation will be a direct result of the major continuing activities under SO 1.3, the Croatia Enterprise Program, and Agribusiness Competitiveness Enhancement program. USAID programs will work directly and indirectly with 3,000 to 4,000 firms from among the tens of thousands of firms comprising the sector. The resulting growth of those firms will be responsible for the net addition of 10,000 jobs between the creation of new jobs and the savings of thousands of additional jobs that would otherwise have been lost during the restructuring process. The programs will work in synchrony to develop a sustainable, fee-for-service based, business services sector and strong, market-based linkages among producers, traders, processors and tourism-related businesses.

HUP, the 5000-member Croatian Employers Association, through its close partnership with USAID under several separate activities, is becoming an even more powerful and focused advocate for private sector business interests and a vibrant free market economy. It will be the premier business association in the future. As a USAID legacy mechanism we will support it to advocate more effectively for the interests of private sector businesses, especially SME's; carry out constructive dialogue with powerful labor unions;



play a leading role on the National Competitiveness Council as the Council seek long-term strategies for increasing Croatia's competitiveness; and to be an ever-growing source of services to SMEs such as training through its training institution and business-to-business trade networking through Global Technology Network.

Association of Management Consultants (AMC), created with USAID support, is an association of one hundred private sector business consultants which promotes professional standards and aggregates the interests of business services consultants and firms. Many of those firms and individuals are being trained and strengthened under USAID's CEP activity. The AMC will serve as an enduring legacy mechanism providing support to SMEs through improved managerial skills, learning to meet EU standards, and increasing their domestic and international competitiveness.

CERC, the Croatian Energy Regulatory Commission, was created with USAID assistance under the energy program, and continues to receive substantial training and technical assistance in order to fulfill its mandate as the strong regulator of an open, market oriented, and efficient energy sector. Under the graduation plan we will continue to strengthen the institutional capacity of CERC. As a legacy mechanism it will lead Croatia into full participation in a Southeastern Europe Regional Energy Market by 2005 and an integrated European Union energy market in the years following.

Two Micro-finance institutions (MFIs), MICROPLUS and DEMOS, which are currently assisted by the program, are already filling a significant gap in the availability of financial services in rural areas. We understand the World Bank will require enabling legislation for MFIs as a condition to its Structural Adjustment Loan. An enabling legal framework is essential to MFI functioning, but close ongoing support under the new Enterprise Development activity will be required during the remaining assistance period for these nascent MFIs to become sustainable legacy mechanisms providing rural finance to SMEs. USAID will expand the geographic focus of both organizations.

The Association of Small Hoteliers is working to promote a new generation of high value-added boutique hotels in Croatia. Beginning from its regional base in coastal Dalmatia and with technical assistance and training from USAID, the Association is moving to the national stage with its message of an environmentally sound, culturally rich tourism experience that will extend the tourism season and provide more and higher quality services for the national and international tourism market. Continued assistance to the Association will provide it with a strong advocacy voice for its membership in moving the current low end mass tourism model of Croatian tourism onto a more sustainable and growth-producing path for the sector.

The National Competitiveness Council (NCC) is a permanent body of high level government officials, corporate leaders, the leaders of the 5 largest labor

unions, and the rectors of the 5 most important universities in the country. Established in 2002 with USAID support, the NCC is working to identify and address the long-term barriers to Croatia's economic development, and USAID will be a partner in those efforts before and after graduation of USG assistance. Most of the institutional work at the NCC has been completed. We will now help link NCC to local competitive activities related to our field-based initiatives.

## **2.5 Expected Results - Contribution to Croatia's Transition Targets:**

USAID's program under SO 1.3 will have significantly met its Intermediate Results targets by graduation and closeout, if we stay the course. The macroeconomic and systemic reforms which USAID and U.S. Treasury have supported in fiscal and banking reform, commercial law, privatization, and commercial law form an important, improving but still incomplete framework within which the private sector must operate. These reforms are key interests of the IFIs and the EU. By the time of EU accession, Croatia will have to have a strongly supportive legal and regulatory framework for the private sector because of the EU's stringent accession requirements.

USAID's planned focus on small and medium enterprise development, agribusiness, and attention to pulling distressed areas into the mainstream of economic opportunities will ensure that the improving macro-economic stability, investment climate, and more competitive and transparent environment translate into higher economic growth and sustainable job creation. The E&E Bureau's *Monitoring Country Progress* analysis indicates that Croatia is progressing well, particularly in first tier structural reforms, but that it lags northern East European nations' achievements at the time of their graduation.

Croatia can attain Northern Tier graduation standards for the transition targets selected during the November 2002 Assistance Review by the planned close-out in FY 2008 if present trends and efforts continue: GDP at or above the 1989 level (now 83 percent); private sector share of GDP at 73 percent (now 62 percent). The employment transition target has been restated as "increase private sector share of employment to 63 percent" (now 56 percent) rather than as an absolute decrease in unemployment (now 16 percent). This is because there are many uncontrollable or even unpredictable factors which might jeopardize reaching a targeted unemployment rate; indeed there remain such significant inefficiencies in the non-privatized large industries and the farming sector that our program impact over the few years remaining may best be seen as mitigating job losses.

## **2.6 What Will Not Be Done**

The major remaining challenges include the still-weak judicial system with attendant corruption; bureaucratic impediments to investment; fragile, if improved fiscal management; high unemployment, and the overhang of inefficient state-owned “strategic” enterprises. Current programs in these areas are being closely coordinated with the European Union, IMF, and World Bank to ensure a smooth transition to their greater resources. For USAID, this Intermediate Result will end over the next one to two years.

Privatization of large-scale “strategic” industries will not be supported during USAID’s assistance period. While these inefficient behemoths represent a significant drag on the growth of Croatia’s economy and its competitiveness, USAID lacks leverage to influence such fundamental political decisions. We have helped below that level. In energy, our assistance is helping set the legal and regulatory framework for unbundling of generation, transmission and distribution functions, so that Croatia can enter into a South East Europe regional market and eventually be integrated into the EU internal electricity market. Ultimately, privatization is likely.

Despite significant impact from USAID’s SME efforts, unemployment will likely remain well above Northern Tier graduation standards, particularly in rural and war affected areas. We expect Croatia will reduce its unemployment rate from 16% to 10% – 12% by departure. We believe focusing on development of a vibrant SME sector and incorporation of lesser developed areas into the economic mainstream is the best means to achieve sustainable job growth.

Other sectors important to Croatia’s economy have not been addressed by USAID in any fundamental way, such as development of national infrastructure, or addressing environmental issues. With graduation pending, we will not be able to expand to new areas.

## **3 Strategic Objective 2.1 – More Effective Citizen Participation and Improved Governance**

As part of the USAID/Croatia graduation plan, the Mission has modified certain aspects of its democracy program in order to better achieve its projected results with the remaining time and resources. The following section describes in detail the shift in focus, the expected results and the legacy we will leave behind for Croatia’s democracy and governance sector.

### **3.1 Modification of Intermediate Results**

The Mission goal of a democratic society and market economy that serve as a cornerstone for stability in the region depends upon effective citizen involvement in decision-making, open information flows between Government

and the public, and responsive, representative governance. SO 2.1 will have two continuing Intermediate Results: *More Effective Citizen Participation in Political and Economic Decision-Making*; and *More Efficient and Responsive Local Governance Systems* (see Figure 4). These IRs are supported by six lower level IRs identified in the results framework diagram. A new lower level IR, *Improved Advocacy and Protection for Selected Vulnerable Groups*, has been transferred from SO 3.4. Activities pertaining to this sub-IR include HIV/AIDS and Trafficking in Persons (TIP). The IR for *Sustainable and Balanced Commercial Media* will be eliminated, as this program will have been completed by the end of FY 2004.

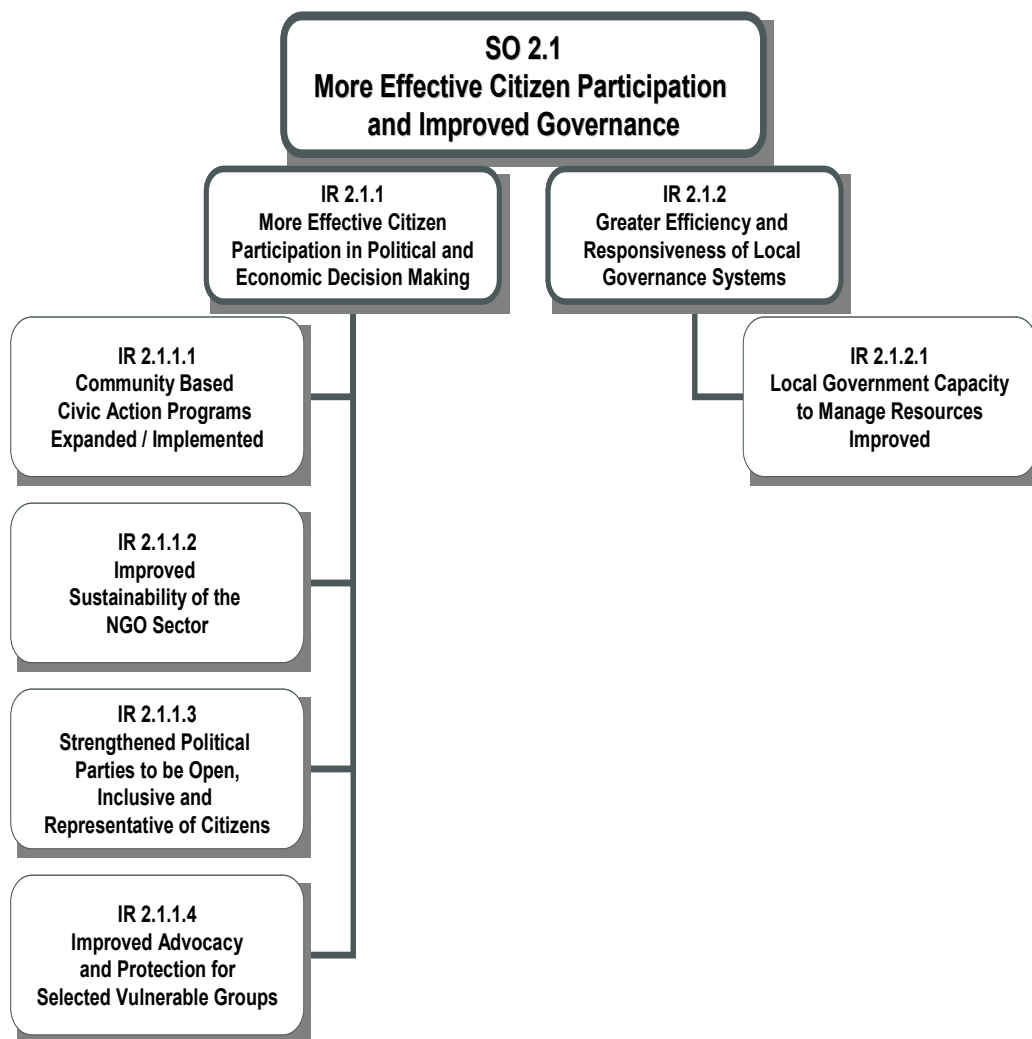
### **3.2 Purpose and Shift of Emphasis**

USAID has supported a broad range of efforts to develop Croatia's democratic institutions, with important, if still partial and fragile, results achieved in good governance and civil society. Assistance in judicial reform, public administration, local governance, strengthening non-governmental organizations and enabling civic participation, political party and legislative strengthening, and independent media development have helped Croatia move toward Western levels of democratic freedoms.

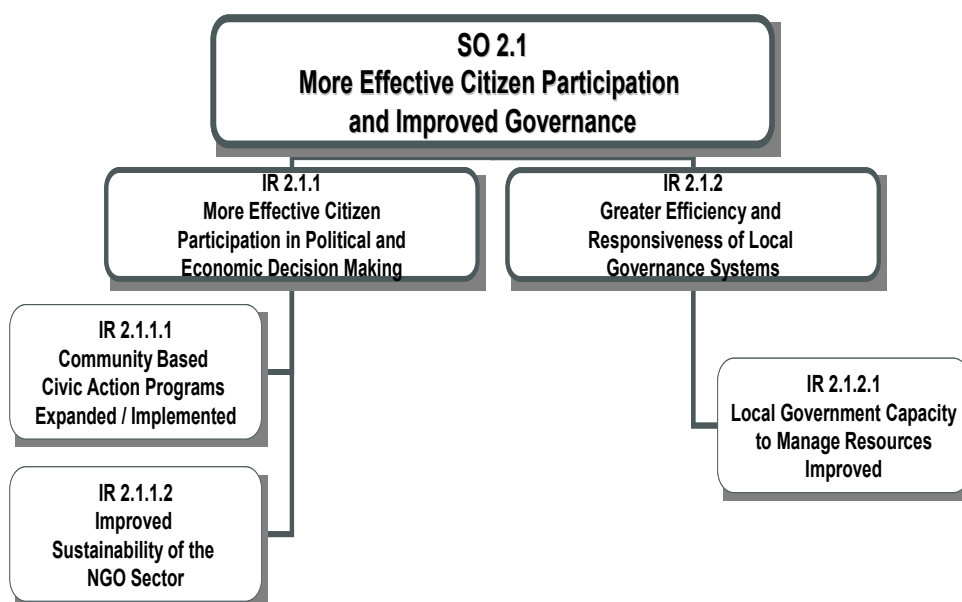
As USAID moves to a more streamlined and consolidated program, it will focus the democracy portfolio in areas showing greatest success and Croatian commitment – especially since 2000. These are areas which will build grassroots demand for continuing democratic reform through civil society activism and transparent and enhanced local governance. This will ensure that we leave behind deeply rooted and sustainable reforms by program graduation. SO 2.1 will concentrate resources until close-out on strengthening local governance and the NGO sector, while leaving to other donors with greater

**Figure 4:**

**SO 2.1: Strategic Framework  
FY2004-FY2006**



**Figure 5: SO 2.1: Strategic Framework  
FY2006-FY2008**



resources and leverage the systemic reform in the judicial sector and national level public administration. Support to political parties, legislative strengthening, elections support, judicial reform and independent media will be completed by October 1, 2004 (see Figure 5). Upcoming parliamentary elections to be held between November 2003 and February 2004 may affect the pace at which some activities close, if there are reinvigorated opportunities to have real impact in the short period remaining. The Local Government and NGO programs will continue, as part of their national programs, their efforts in the lesser developed and war-affected regions of Croatia, helping to protect previous Mission investments in these areas.

Croatia now enjoys a vibrant, capable and varied independent media which operates within a favorable legal environment. USAID support to independent print and broadcast media and to journalists' professional associations resulted in 24 media outlets generating revenue and self sustaining, providing balanced and objective alternatives to government information. As the Pro Media project ends, Intermediate Result 2.1.2, *Sustainable and Balanced Commercial Media*, will be successfully completed in FY 2004.

An Intermediate Result previously reflected in SO 3.4, **Mitigation of Adverse Social Conditions and Trends**, is now placed under SO 2.1 as a lower level IR. This is IR 2.1.1.4 *“Improved Advocacy and Protection for Selected Vulnerable Groups”*, and it permits completion of ongoing work in Anti-Trafficking in Persons and HIV/AIDS. This IR will be completed during the 2004-2006 timeframe.

➤ IR 2.1.1: More Effective Citizen Participation in Political and Economic Decision-Making

IR 2.1.1 is the result that contributes to the demand side of the Strategic Objective by creating mechanisms through which ordinary citizens can be heard and can influence public policy choices. Having an activist citizenry placing demands on government for reform will be even more important in the future as the country finds its way in the larger EU and international system. Current programs contributing to this IR include NGO sector development, support for democratic and transparent political parties developing effective outreach to citizens, strengthening the legislature’s capacity to engage citizens, labor union development (now in SO 3.4), creation of a favorable legal environment for citizen participation, and public education campaigns to explain reform programs. Independent Media strengthening activities under the current IR 2.1.2, also support citizen participation. Under this graduation plan most assistance under this IR will be concentrated in an expanded CroNGO program, consolidating and strengthening civil society so that NGOs can be a continuing voice for democratic and economic reforms. The future of the political party programs will be determined after the 2003 national elections.

Benefiting from USAID’s input to legislation on associations and charitable lending, the NGO sector operates within a generally favorable legal environment and with strong support from the Croatian Government’s Office for Cooperation with NGOs. The lower level IR 2.1.1.1 in the Country Strategic Plan, *Enhanced Enabling Environment for Growth of Effective CSOs and NGOs*, will be successfully completed in FY 2004 as the International Center for Not-for-Profit Law ends its work on legislative analysis and improving the capacity of lawyers to support the sector. USAID’s primary focus for the remainder of the assistance period will be on direct NGO capacity building through the CroNGO program.

CroNGO has strengthened intermediate support organizations, developed individual NGOs’ service capacity through small grants, and created networks among grassroots organizations and with local governments. It is developing a sustainable core of nine sectoral and three grant-making NGOs which will serve as legacy mechanisms to ensure future continued organizational and financial capacity building, after USAID’s graduation. As part of the graduation plan, CroNGO will be extended and significantly expanded to focus even more directly on financial viability of grant making NGOs,

expanding training capacity, developing a code of ethics, promoting corporate responsibility and philanthropy, and improving the public image of the sector.

NGOs are an important mechanism for supporting reintegration of refugees and displaced persons. As community grassroots organizations, they provide advocacy and services on all community issues and many have been long involved in human rights, community development and services to vulnerable groups. CroNGO will continue to operate in all regions, including within war-affected areas, as it develops capacity within these as well as other NGOs.

➤ IR 2.1.2: More Efficient and Responsive Local Governance Systems

This IR represents the supply side of the SO by building the capacity of local governments to manage resources, establish mechanisms to enhance citizen access to local government, and set up transparent and accountable governing procedures that the public can scrutinize.

Croatian legislation in 2001 on local government reform created a decentralization plan which placed significant new fiscal and administrative responsibilities on nascent local governments but did not fully empower them with financial nor human resources. The current Local Government Reform Program (LGRP) provides advice at the national level, through the Ministry of Justice, Administration and Local Government, on evolving needs in the areas of self-regulation and intergovernmental relations. Also contributing to decentralization is assistance provided under SO 1.3 through advisers to the Ministry of Finance and Deputy Prime Minister on the evolving legal and regulatory framework for local government finance and intergovernmental relations. LGRP also directly assists local authorities in pilot cities with “best practices” modules in financial and asset management, local economic development, information management and citizen participation. The program has had immediate impact, as assisted local governments are now showing increased revenues, improved asset management practices, and improved municipal services using transparent processes with significant citizen participation – such as through published budgets, public hearings, web sites, and information dissemination through NGOs and community centers. Under our graduation scenario, we expect future EU activities in this sector will build upon our programs.

As part of the graduation plan, a follow-on LGRP program will significantly expand the program in scope and geographic area, creating a sustainable institutional base for continued municipal development after USAID’s departure. Work at the municipal level focuses where other donors have not concentrated and leaves a legacy of trained leaders at the local level, where real reform and community impact are taking place. In addition to rolling out its geographic reach to 65 cities, towns and municipalities all across Croatia, it will add three new “best practices” modules -- in open and competitive procurement, developing proposals to access international donor and private



capital, and performance monitoring. It will also develop a mass of up to 80 consultants trained to roll out these “best practices” modules, on a fee-for-service or, where needed, cost-sharing basis. Where communities are too small to provide efficient municipal services, inter-municipal cooperation through clustering will be encouraged and introduced through such mechanisms as participant training.

Both the current program and follow-on recognize the responsibility which local governments in war-affected areas bear for promoting and facilitating refugee returns and their full integration into community and economic life. Memoranda of Understanding with participating local governments are and will continue to be required to ensure equal rights, services and where appropriate, protections for displaced persons, returnees and refugees. A significant portion of LGRP II efforts will be in such disadvantaged areas, including all municipalities now assisted under the SO 3.1 ECRA program.

Achievement of this IR will increase Government’s capacity to respond to the needs of individuals and groups at the grassroots level in a manner that engenders trust and confidence in basic governance. Expansion and broadening of this program to a critical mass of local governments engaging in improved, transparent and responsive practices will create a platform for sustaining reform efforts, both those launched by the GOC and those encouraged by other donors.

### **3.3 Critical Assumptions**

- The Croatian economy will continue to grow by at least 3 percent annually, enabling NGOs, associations and other private institutions to become sustainable;
- The GOC’s decentralization process will continue, devolving fiscal and political authorities to local governments, thereby increasing their ability to increase revenues and provide services;
- The GOC introduces judicial and public administration reforms in systematic fashion. These reforms conform to EU/Council of Europe standards;
- EU and World Bank programs address national-level public administration, judicial reform, and decentralization needs.

### **3.4 Sustainability – Legacy Mechanisms**

Both the civil society and local governance programs seek sustainable results. The following organizations and/or institutions will maintain the momentum of Croatia’s democratic transition and sustain previous U.S. initiatives.

Nine intermediate support organizations and three grant-giving NGOs will serve as legacy mechanisms for our program. These NGOs as well as others will provide a mechanism for people to voice their views on reform issues while at the same time continuing to strengthen smaller NGOs' organizational and financial capacity after USAID's departure. These organizations will become more sustainable by benefiting from USAID's comprehensive assistance, which is building capacity of their trainers, developing self-assessment tools, and providing technical assistance and training to accompany small grants.

The Foundation for Civil Society Development will also be an important mechanism for sustaining USAID's initiatives in the NGO sector. A generally favorable legal framework exists, and further project assistance will include encouraging legislation on philanthropic giving and corporate responsibility. The Croatian Government Office for Cooperation with NGOs is in the process of establishing this new national Foundation which will provide a continuing indigenous impetus for strengthening NGOs through grant-making, training, cross-sectoral linkages, evaluation and public education.

In the cadre of local governments, USAID's key legacy organizations will be the 65 USAID-assisted municipalities and towns. These municipalities and towns will be in place to adopt "best practices" in areas from financial management and budgeting to accessing international donor and private capital – and to do so through transparent processes which reflect citizen participation.

The Association of Cities and Municipalities will promote policy dialogue/reform and be a strong national-level advocate for local government interests. USAID will work to strengthen the Association that will serve as an advocate before the GOC in the continuing decentralization process, and extend improved governance across Croatia.

A cadre of financially viable private consultants and an association of consultants, created as a result of USAID programs, will help localities to acquire skills and services needed to improve their functioning. The development of a market for and cadre of trained private consultants to service the needs of local governments will result in an indigenous and financially viable means to continue to expand improved practices beyond this program. In parallel, USAID will explore the development of a sustainable national-level training institution for continued professional development of local government staff – an area where the EU may pick up.

In independent media, the sustainable network of 24 television, radio and print media outlets providing balanced and objective alternatives to official sources constitute a significant legacy for democratic values.

### **3.5 Expected Results - Contribution to Croatia's Transition Targets:**

USAID's support to democracy and governance has yielded significant results in the short period since the transition to democratic rule in January 2000. Croatians now freely elect their leaders through processes which are increasingly transparent and competitive. Over 22,000 registered NGOs work in health, environmental protection, human rights, community development, and the needs of disabled persons, women and youth. Financially viable independent media operate freely, providing balanced alternatives to government sources of information. Decentralization of governmental responsibility and authority, citizen participation and improved public administration with reduced corruption, have all begun to take hold. Human rights are generally respected, and the government has committed to reintegration of ethnic Serbs, although the actual process of providing effective support has sometimes been slow and reluctant.

Freedom House's Nations in Transit (NIT) indicators confirm Croatia's progress since 1999/2000 in democratization, but also demonstrate a gap compared to Northern Tier East European countries at the time of their graduation. USAID's program emphasis on local governance and NGO sector development, with its continuing efforts in political party/legislative strengthening, should help bring Croatia close to Northern Tier standards in political process, civil society and local governance. The NIT analysis reflects events through December 2001, and probably understates the strength of Croatia's democratic freedoms today. USAID's electoral support is strengthening the democratic operations of and capacity of political parties to reach out to constituents, at national and local levels. As a result, Croatia's indicators for development of multi-party systems and popular participation in political processes should improve. Comprehensive NGO sector development in CroNGO is building the organizational and financial capacity and viability of citizen groups, and stimulating interest group formation and participation. In governance, USAID support to the decentralization process and capacity building of local bodies will significantly improve Croatia's relative position in governance.

### **3.6 What Will Not Be Done**

For Croatia to achieve levels of democratic reform comparable to graduate countries, it must accelerate key judicial reforms and improve public administration. Government is too big and too controlling. However, we have concluded that systemic reform in public administration, rule of law, judicial reform and anti-corruption will require the longer time frame and greater leverage of the EU, World Bank and other donors. USAID's programs have had positive impact but have not sparked the fundamental political will to reform and modernize systems and institutions. We believe that the necessity for Croatia to meet EU accession requirements is likely to provide the required leverage, and that our investments to date in many cases provide an excellent

springboard for continuing technical progress through the EU/CARDS and World Bank programs.

In decentralization and local governance, we will leave behind a critical mass of community leadership listening to citizen input and using modern governance tools. We are not addressing the size and structure of local governments but believe that the necessity to harmonize with EU standards will require that this be addressed relatively soon. Fiscal decentralization is incomplete. We are counting on the EU to help the GOC further devolve the necessary authorities, so localities can raise more resources to effectively meet their new responsibilities.

LGRP II will explore establishment of a national training capacity for public administration, but there will not be an established discipline of public service, including for local governance. The EU may pursue creation of such an institute for national level public service.

In media, substantial gains have already been achieved in developing viable, independent and varied print, TV and radio news sources, but state-owned media remain the dominant source of programming. EU standards regarding licensing and regulation should result in reforms over time, if not privatization.

In health, we will complete our ongoing activities in HIV/AIDS awareness and Healthy Cities, but we have not and will not engage in any fundamental reform of the sector.

## **4 Cross-cutting Initiatives**

### **4.1 *Participant Training***

One of the most enduring legacies of USAID assistance in Croatia will be the large number of U.S. trained Croatian professionals. Human capacity development is a fundamental building block of any stable society. Education and training are required to enable full participation in community, national and global development. A nation's ability to contribute to the world economy, as well as to manage its own, is directly related to the development of its human resources.

Participant training in the U.S., within Croatia and in third countries continues to be an important element of our sectoral programs and a critical approach in our graduation strategy. In addition to developing knowledge and skills to enhance the performance of targeted individuals or organizations, USAID's participant training program strives to strengthen relationships between the U.S., Croatia and the European Community.

Creating a core of individuals and organizations that are familiar with proactive, entrepreneurial ways of doing business, state-of-the-art technical

approaches, and are engaged in a depth of professional linkages within and outside Croatia, is critical to building a strong constituency for continued reform. In many cases our programs will leave behind sustainable training capacities, as for example the associations of business consultants, HUP's SME training institute, the NGO foundation, and the Association of Cities and Municipalities.

Additionally USAID/Croatia's participant training program will look to areas of opportunities not specifically addressed through our existing activities but are nevertheless critical to achieving our overall objectives by exposing future Croatian leaders to democratic values, to American methodologies and procedures and to our legal, legislative and executive management practices. This training will seek to not only build the capacity of individual leaders but also foster long lasting ties between Croatia and the United States. Specific training in drafting legislation, an area not covered by existing activities, will provide a cadre of mid and senior level GoC bureaucrats who will be charged with drafting new legislation that meets the requirements of European accession. Visits to the US by Members of Parliament, and the judiciary will serve as political legal bridges between our countries. We will continue to look for targets of opportunity such as these individual and bridge-building trainings that will bring long-term benefits that solidify our two countries' relationships.

The bulk of the funding for participant training is budgeted within the individual SO budgets in support of the USAID/Croatia's sectoral objectives in building a democratic society with a market-oriented and competitive economy. As part of the consolidation of the portfolio, no additional stand-alone funding is planned for anti-corruption, environment or information and communications technology efforts. Funds for Mission requirements such as evaluations, planning and close-out needs will be reserved as a cross-cutting line item.

## **5 ACRONYMS and ABBREVIATIONS**

|            |   |
|------------|---|
| ACE        | Agribusiness Competitiveness Enhancement program          |
| BDS        | Business Development Services                             |
| CEP        | Croatia Enterprise Promotion program                      |
| CERC       | Croatia Energy Regulatory Commission                      |
| CIRP       | Community Infrastructure Rehabilitation Program           |
| CroNGO     | Croatian Nongovernmental Organizations (project)          |
| EBRD       | European Bank for Reconstruction and Development          |
| E&E Bureau | Europe and Eurasia Bureau (of USAID)                      |
| EC         | European Commission                                       |
| ECRA       | Economic and Community Revitalization Activity            |
| EU         | European Union  |
| EU/CARDS   | European Union pre accession assistance                   |
| FSN        | Foreign Service National                                  |
| FY         | Fiscal Year   |
| GDP        | Gross Domestic Product                                    |
| GOC        | Government of Croatia                                     |
| HEP        | Croatian Electric Power Company                           |
| HIV/AIDS   | Human Immune Virus/Acquired Immune Deficiency Syndrome    |
| HUP        | Croatian Employers Association                            |
| ICASS      | International Cooperative Administration Support Services |
| ICNL       | International Center for Not-for-Profit Law               |
| ICT        | Information and Communications Technology                 |
| ICTY       | International Criminal Tribunal for the former Yugoslavia |
| IFI        | International Financial Institution                       |
| IMF        | International Monetary Fund                               |
| IR         | Intermediate Result                                       |
| LGRP       | Local Government Reform Program                           |
| MFI        | Micro Finance Institution                                 |
| MOJ        | Ministry of Justice, Administration and Local Government  |
| NIT        | Nations in Transit  |
| NGO        | Non-Governmental Organization                             |
| NXP        | Non Expendable Property                                   |
| OE         | Operating Expenses  |
| OSCE       | Organization for Security and Cooperation in Europe       |
| RSC        | Regional Services Center (of USAID)                       |
| SAA        | Stabilization and Association Agreement (of EU)           |
| SEED       | Support for East European Democracy (funding)             |
| SME        | Small and Medium Enterprise                               |
| SO         | Strategic Objective                                       |
| TIP        | Trafficking in Persons                                    |
| USAID      | United States Agency for International Development        |
| USDH       | United States Direct Hire                                 |
| USPSC      | United States Personal Services Contractor                |
| USG        | United States Government                                  |
| WB         | World Bank  |